BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

I.

OPINION IN THE COURT BELOW.

The opinion of the United States Circuit Court of Appeals for the Fifth Circuit is reported on page ....., Volume ....., Federal Reporter, Second Series. It is found on pages 59 to 63 of the Record. The opinion was written by Judge Holmes and concurred in by Judges Hutcheson and Foster.

II.

STATEMENT OF JURISDICTION.

(a) This is a suit by Southwestern Hotel Company against the United States to recover $989.24, together with interest at 6% from March 10, 1939. Jurisdiction is based upon Section 41, Tit. 28, U. S. C. A. (R. S. of U. S., Sections 563, 629), which read in part as follows:

> "The District Courts shall have original jurisdiction as follows:
>
> "(1) . . . where the matter in controversy exceeds, exclusive of interest and costs, the sum or value of $3000.00, and (a) arises under the Constitution or laws of the United States, . . . The foregoing provision as to the sum or value of the matter in controversy shall not be construed to apply to any of the cases mentioned in the succeeding paragraphs of this section . . .
>
> "(5) *Cases under internal revenue, customs, and tonnage* laws. Fifth. Of all cases arising under any law providing for internal revenue, . . . "

(b) The statutory provision which is believed to sustain the jurisdiction of this Honorable Court is Section 347, of Tit. 28, U. S. C. A. (Judicial Code, Section 240, amended). The application is filed under Section 5, Rule 38 (former rule 35) of the Rules of the Supreme Court.

(c) The Judgment of the Trial Court is dated March 23, 1940 (R. 37). The Judgment of the Circuit Court of Appeals is dated November 19, 1940 (R. 63).

(d) This case involves the determination of important questions of Federal law which have not been but should be settled by the Supreme Court.

(1) The lease between Albert Mathias and wife, as Lessors, and Southwestern Hotel Company, as Lessee, provides in Article II for cash monthly rentals, in fixed amounts, during the period from September 1, 1933, to August 31, 1950. It provides that after August 31, 1950, there shall be substituted for these fixed monthly rentals a monthly rental which would yield a net annual return of 6% on the then ground value of the Mathias property. The lease also provides that as "Additional Money Rentals" the Lessee should pay the sums due and to become due on the Pacific Mutual Life Insurance Company mortgage, upon which there remained, after September 1, 1933, a balance of $424,000.00, maturing in fixed amounts each year for a period of years. It is further provided in the lease that the Lessee shall be required to reduce the principal amount of the mortgage not less than $12,000.00 a year during the first three years of the lease, and not less than $20,000.00 a year during the succeeding years of the lease. It also provides that the Lessor should be required to join with the Lessee in refinancing agreement so as to extend and renew the indebtedness

secured by the mortgage from time to time to permit payments on the principal of not less than $20,000.00 a year after the first three years. Section 2 of Article III of the lease provides a way for assistance to the Lessee to prevent it from being required to pay more than $12,000.00 a year during the first three years of the lease. Can the Lessee, under such a lease, deduct for the fiscal year ending August 31, 1935, as a part of its rental expense, the sum of $18,000.00, the actual amount payable during that year, or can he only deduct $4283.00, an amount equal to $424,000.00 divided by ninety-nine, the number of years that the lease had to run, as held by the United States Circuit Court of Appeals?

(2) Under the lease such as is referred to in the preceding question, can the Lessee deduct for the fiscal year ending August 31, 1935, as a part of his rental expense, the sum of $18,000.00, the actual amount payable during that year, or can he only deduct $12,720.00, an amount equal to $424,000.00 divided by thirty-three and one-third, the number of years which the building on the leased premises will be presumed to last, as held by the Trial Court?

III

STATEMENT OF THE CASE.

The statement of the case in the preceding petition, pages 4 to 10, is hereby made a part of this brief.

The proceedings in the Circuit Court of Appeals were sufficient to raise the questions here presented. The opinion of the Circuit Court of Appeals is found on pages 59 to 63 of the Record.

IV.

SPECIFICATION OF ERRORS.

In affirming the judgment of the Trial Court, the Circuit Court of Appeals erred in the following particular:

The lease between Albert Mathias and wife, as Lessors, and Southwestern Hotel Company, as Lessee, provides in Article II for cash monthly rentals in fixed amounts during the period from September 1, 1933, to August 31, 1950. It provides that after August 31, 1950, there should be substituted for these fixed monthly rentals a monthly rental which would yield a net annual return of 6% on the then ground value of the Mathias property. The lease also provided that as "Additional Money Rentals" the Lessee should pay the sums due and to become due on the Pacific Mutual Life Insurance Company mortgage, upon which there remained, after September 1, 1933, a balance of $424,000.00, maturing in fixed amounts each year for a period of years. It is further provided in the lease that the Lessee shall be required to reduce the principal amount of the mortgage not less than $12,000.00 a year during the first three years of the lease and not less than $20,000.00 a year during the succeeding years of the lease. It also provides that the Lessor should be required to join with the Lessee in refinancing agreements so as to extend and renew the indebtedness secured by the mortgage from time to time to permit payments on the principal of not less than $20,000.00 a year, after the first three years. Section 2 of Article III of the lease provides a way for assistance to the Lessee to prevent it from being required to pay more than $12,000.00 a year during the first three years of the lease. The Circuit Court of Appeals held that the Lessee could not de-

duct for the fiscal year ending August 31, 1935, as a part of its rental expense the sum of $18,000.00, the actual amount payable during that year as rent, but could only deduct $4283.00, an amount equal to $424,000.00 divided by ninety-nine, the number of years that the lease had to run, and that therefore the Judgment of the lower court in permitting a deduction of $12,720.00, an amount equal to $424,000.00 divided by 33-1/3, the number of years which the building on the leased premises would be presumed to last, should be affirmed.

The Circuit Court of Appeals, in making said decision, has erroneously decided an important question of Federal law, which has not been, but which should be, settled by the Supreme Court.

V.

SUMMARY OF ARGUMENT

We shall present our views under one point.

In this case, the lease provided in one article for monthly cash rentals in fixed amounts during the period from September 1, 1933, to August 31, 1950. It provided that after August 31, 1950, there should be substituted for these fixed monthly rentals a monthly rental which would yield a net annual return of 6% on the then ground value of the Mathias property. The lease also provided that as "Additional Money Rentals" the Lessee should pay certain amounts maturing each year on the principal of a mortgage secured by a lien upon the leased property, and that the mortgage might be so handled by the Lessee as to permit payments of not less than $12,000.00 a year during the first three years and $20,000.00 a year during succeeding years of the lease. It

is our contention that the annual amounts paid by the Lessee on the principal of the mortgage as a part of the rentals should be considered as an annual rental expense, and should be deducted as such in arriving at the net income of the Lessee. We think our contention is fully supported by Section 23(a) of the Revenue Act of 1934, 26 U. S. C. A., which reads:

> "Section 23. Deductions from Gross Income.
>
> "In computing net income, there shall be allowed as deductions:
>
> "(a) Expenses . . . and rentals or other payments required to be made as a condition to the continued use or possession for purposes of the trade or business of property to which the taxpayer has not taken or is not taking title or in which he has no equity."

These payments are expressly designated in the lease as "Additional Money Rentals", and if the lease were cancelled the obligation to continue to make the payments on the mortgage would terminate in the same manner as the obligation to make any other unmatured rental payments. Moreover, if the tenant failed to make these payments on the mortgage as they matured, the right to occupy the premises would be subject to termination. Clearly, these were "payments required to be made as a condition to the continued use or possession . . . of property . . . ". If the lease terminated the obligation to continue to make the payments ceased. If the payments were not made, the right to continued occupancy of the premises ceased.

The opinion in *Midtown Tower, Inc. v. Commissioner of Internal Revenue,* 40 B. T. A. 116, fully set out as Appendix One to this brief, is directly in point, and fully

sustains all of our contentions. The Commissioner of Internal Revenue made the same contentions in that case that we are making here. Great deference should be shown to the expressed judgment of the Commissioner of Internal Revenue and of the Board of Tex Appeals in matters of this character. We do not believe it would be possible to find another case so similar in all respects to ours. In that case as in ours, the original lease was made with another lessee, who signed the mortgage upon which the payments were to be later made. The original Lessee dropped out of the picture, and the new Lessee was the taxpayer before the Board of Tax Appeals. *In that case, as in ours, the new Lessee did not assume or become personally liable upon the mortgage. His only obligation to pay the principal installments becoming due on the mortgage was the obligation made as the Lessee in the lease, and he agreed to pay such principal sums as a part of the rent.*

VI.

ARGUMENT.

Point.

Under a lease such as is shown to have existed in this case, by which the Lessee was required to pay as "Additional Money Rentals" the principal amounts accruing each year on the note held by the Pacific Mutual Life Insurance Company the amount paid by the Lessee on the principal amount of the mortgage should be considered as annual rental expense in calculating the annual net income of the Lessee for tax purposes.

Argument.

The lease between Albert Mathias and wife, as Lessors, and Southwestern Hotel Company, as Lessee, provides in Article II for cash monthly rentals in fixed amounts during the period from September 1, 1933, to August 31, 1950. It provides that after August 31, 1950, there should be substituted for these fixed monthly rentals a monthly rental which would yield a net annual return of 6% on the then ground value of Mathias' property. The lease also provided that as "Additional Money Rentals", the Lessee should pay the sums due and to become due on the Pacific Mutual Life Insurance Company mortgage, upon which there remained after September 1, 1933, a balance of $424,000.00, maturing in fixed amounts each year for a period of years. It is further provided in the lease that the Lessee shall be required to reduce the principal amount of the mortgage not less than $12,000.00 a year during the first three years of the lease, and not less than $20,000.00 a year during the succeeding years of the lease. It also provides that the Lessor should be required to join with the Lessee in refinancing agreements so as to extend and renew the indebtedness secured by the mortgage from time to time, to permit payments on the principal of not less than $20,000.00 a year after the first three years. Section (2) of Article III of the lease provides a way for assistance to the Lessee to prevent it from being required to pay more than $12,000.00 a year during the first three years of the lease.

A reading of the terms of the lease makes it quite evident that the parties intended that the Lessee should pay approximately, and in any event not less than, $12,000.00 a year on the principal during the first three years

and $20,000.00 a year during the period required to completely retire the mortgage. The lease, as drawn, is susceptible to the construction that Lessor and Lessee both realized that during the first seventeen years of the lease, while the building was camparatively new, the rents should be higher than during the balance of the lease, unless the ground value of the property should increase, and that during these high income years the rent should be sufficient to pay out practically the entire principal amount of the Lessor's mortgage indebtedness. In other words, it was contemplated that during the first seventeens years of the lease, with a modern, recently constructed building, the Lessee should be able to pay the fixed monthly rents described in Paragraph II, and also be able to either pay the Pacific Mutual Life Insurance Company mortgage in full, or to reduce it to a comparatively small sum. It was contemplated that after seventeen years, when the building would be twenty years old and obsolete, the rent should be based solely on the ground value of the property. It seems to us reasonable for the parties to have thought it proper to have a larger annual rental expense during the profitable years of the building than during the more unprofitable years. It seems unreasonable for the Government to insist that the Lessee should, in the payment of income taxes, pay upon an arbitrary annual expense instead upon the actual annual expense.

Let us suppose that the lease had provided for cash monthly rentals, as set up in Article II of the lease, and then, instead of providing for payments on the Pacific Mutual Life Insurance Company mortgage, had provided that as additional monthly rentals the Lessee should pay $20,000.00 a year for the first twenty-one years of the lease, and that during the last seventy-eight years of the

lease the total annual money rents should be 6% of the ground value of the property. We do not think that any one would then claim that during the first twenty-one years the Lessee should not deduct, as a part of his annual rental expense, the full $20,000.00.

Suppose, for instance, that the lease, in recognition of the probable decreasing rental value of the property, had provided that during the first thirty-three years the total annual money rental should be $24,000.00; that during the second thirty-three years it should be $20,000.00, and during the last thirty-three years it should be $15,000.00. Would anyone contend that the Lessee should not be allowed to deduct each year the actual amount of rent paid during that year? The mere fact that there is a variation in the amount of rent payable during the different periods of the lease does not call for a proration of rent over the entire lease for income tax purposes. For instance, the lease actually provides in Article II for the following schedule of monthly rental payments:

September 1, 1933, to August 31, 1935—$1250.00 a month;

September 1, 1935, to August 31, 1940—$1500.00 a month;

September 1, 1940, to August 31, 1945—$1750.00 a month;

September 1, 1945, to August 31, 1948—$2000.00 a month;

September 1, 1948, to August 31, 1950—$2500.00 a month.

Yet no one has or would suggest that these rents for the first seventeen years should be added together and then

divided by seventeen to determine the average annual rent under this section of the lease, and that the taxpayer should be allowed to deduct this average annual money rent, instead of the actual money rent due, for the particular year in question.

Let us assume that the lease had provided for the varying cash rentals set out in Article II of the lease, and had then provided that during the first twenty-three years of the lease the Lessee should pay as additional annual rents 10% of the gross annual income from the hotel, with the proviso that this additional rent should be at least $12,000.00 during each of the first three years and at least $20,000.00 a year during the succeeding twenty years. It is quite probable that the total annual rental would vary greatly each year, because of the varying amounts of the gross annual income. We do not think that any one would contend that for income tax purposes these extra annual payments, based on 10% of the gross income during the first twenty-three years, should be amortized over the life of the building, or should be amortized over the whole ninety-nine year term of the lease. Certainly it is permissible to provide for varying amounts of annual rentals to be determined by factors not entirely within the control of the Lessor and Lessee without being compelled to prorate this rental expense over the life of the lease. After all, the amount payable each year is the rental expense for that and no other year.

If, merely because under the lease the Lessee pays varying amounts of rent during different periods of the lease, the Lessee is required to prorate the total rent over the life of the lease, or over the particular period in question, then it seems to us that in order to be consistent the Government should take the total of the rents to be

paid during the entire period in question and divide this sum by the number of years in question, and then take this amount as the average annual rent to be deducted each year.

The Government says that the $424,000.00 to be paid by the Lessee as rents under Article III of the lease should be paid over a period of 33-1/3 years. The Circuit Court of Appeals says it should be prorated over a period of ninety-nine years. We say, in order to be consistent, we should take the total rents payable under Articles II, III and IV, which last Article provides for payment of taxes by Lessee, and divide that total by 33-1/3, or by 99, to obtain the real average annual rental for the period in question.

This, of course, would not be a practical suggestion, since it would be difficult to prophesy what the taxes would be during said period of 33-1/3 years or 99 years, and it would be difficult to prophesy what the rent under Article II would be after September 1, 1950, when it will be fixed to yield 6% per annum on the then ground value of the property. It seems to us that the only practical solution is to permit deduction of the actual total amount which becomes payable under the lease as rent during the particular year in question.

If, as a matter of fact, the annual payments are paid as rents or expense for the continuing use of the premises, the actual amount which thus becomes payable during the tax year is deductible under the very terms of the statute itself. Section 23(a) of the Revenue Act of 1934, 26 U. S. C. A., reads:

> "Section 23. Deductions from Gross Income.
>
> "In computing net income, there shall be allowed as deductions:

> "(a) Expenses . . . and rentals or other payments required to be made as a condition to the continued use or possession for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title, or in which he has no equity."

There is no rule which says that merely because the rental varies in amount from year to year the amount to be deducted each year shall be the average annual rent for the period in question.

The Commissioner of Internal Revenue relied upon that portion of Treasury Regulations 86 under Revenue Act of 1934, which reads:

> "Article 23(a)—10. Rentals . . . The cost borne by a lessee in erecting buildings or making permanent improvements on ground of which he is lessee is held to be a capital investment, and not deductible as a business expense."

and also upon the provisions of Article 22(a)—13 of Treasury Regulations 86 under the Revenue Act of 1934 with reference to "Improvements by Lessee". It is upon this basis that he prorated the $424,000.00 over the life of the building, which is assumed to be 33-1/3 years.

A complete answer is that the Lessee erected no improvements. No justification exists for any application of the above quoted Treasury Regulations to the facts and issues of this case, for the simple reason that the Lessee built no improvements, nor did it agree to pay for any improvements. It merely agreed to pay additional money rentals in amounts required to retire a mortgage upon which the principal would be payable in amounts of at least $12,000.00 a year during the first three years and in amounts of at least $20,000.00 a year thereafter.

Our lease as drawn expressly provides that the payments of the Pacific Mutual Life Insurance Company mortgage are to be considered by the parties as "Additional Money Rentals". The use of these words has a clear legal significance. These words mean that the parties understood and intended, and therefore agreed, that the payments which were to be made from time to time on the mortgage of the Pacific Mutual Life Insurance Company should be considered as rental payments. This meant that if at any time the Lessor should, for any default of the Lessee, terminate the lease, the Lessee would thereafter be relieved from paying installments on the mortgage which had not become due up to the date of the cancellation of the lease. In other words, under the lease as drawn, a termination of the lease would relieve the Lessee from its obligation to continue to make payments on the mortgage of installments which had not become due up to the date of the cancellation of the lease. In other words, under the lease as drawn, a termination of the lease would relieve the Lessee from its obligation to continue to make payments on the mortgage of installments which had not actually become due at the time of the termination, just as such cancellation would relieve the Lessee from making payment of any other unmatured rental payments.

To make this clear, we call attention to the fact that the lease provides that the Lessee shall pay insurance premiums during the entire term of the lease; that it shall pay the taxes accruing on the property during the ninety-nine year term of the lease, and that it shall keep up the repairs on the property during the term of the lease. If at any time the lease were cancelled, the Lessee would, of course, be relieved from keeping any of these covenants for any portion of the term of the lease

subsequent to the date of cancellation. Since the parties expressly agreed that the covenant to pay the principal installments on the Pacific Mutual Life Insurance Company mortgage should be considered as covenants to pay "Additional Money Rentals", a termination of the lease would also relieve the Lessee from paying unmatured installments on the mortgage.

A bonus paid for the making of a lease is a sum which is absolutely payable as a consideration for the execution of the lease. It is not a sum which is to be paid conditioned on the continued life of the lease. If the parties had intended that the obligation to pay the mortgage should be considered as a bonus for the making of the lease, and not as recurring rentals under the lease, they would have made this intention clear, by using substantially the following language:

> "Lessee agrees to pay as a bonus for the execution of this lease the sum of $424,000.00 as evidenced by the Lessee's assumption and agreement absolutely to pay the indebtedness held by The Pacific Mutual Life Insurance Company of California, and secured by a mortgage upon the leased premises, it being understood that since this payment is to be considered a bonus for the execution of the lease, the cancellation of the lease shall in no way relieve the Lessee from the payment of the full amount of such mortgage."

If the agreement had been in the language just quoted, the Lessee would, upon the termination of the lease, have been no more entitled to be relieved from paying unmatured portions of the mortgage than it would have been entitled to recover any portion of a cash bonus which it might have paid upon the inception of the lease. If the parties had agreed that the $424,000.00 should be considered as a bonus for the execution of the lease, then the

holding of the Court of Civil Appeals here would have been correct, and would have been fully supported by the cases upon which it relies. The cases do not actually support that Court's contention in this case.

If the principle for which the United States contends is that there should be allowed each year an average rental expense calculated either over the life of the building or over the full term of the lease, there is no basis of fact upon which to arrive at what the average rental expense would be, if the entire rental expense under Articles II, III and IV of the lease are considered. It would certainly not be fair to prorate only a part of the variable rents and take the amounts as actually paid each year for the other items of rental expense.

The Government is not even consistent in its theory. While asking an average annual amount for the rentals paid in the form of payments on the mortgage, it uses the actual amounts payable each year under Article II, which are themselves variable amounts. It also permits deduction for actual amounts paid each year for taxes and insurance payments, without taking an annual average of these items.

It is highly probable that after 1950 the total annual rental payments of all kinds, paid by Southwestern Hotel Company, will be in excess of the total rental payments of all kinds during the period prior to 1950, yet under the principle contended for by opposing counsel the Southwestern Hotel Company should not now be allowed to deduct its annual current rental expense, because of the apparent assumption that the present expense is more than what it will be hereafter.

The Supreme Court, in numerous cases, has laid

down the rule that tax laws and regulations should be given a practical interpretation and a practical application. We think that when, as in this case, payments on a mortgage debt are to be made over a period of years, as a part of the monthly rentals, in amounts which must be at least $12,000.00 a year during the first three years and at least $20,000.00 a year during the balance of the lease until the mortgage debt is paid, and by the terms of the lease the continued existence of the lease is conditioned upon the prompt payment of these recurring amounts, the sums actually payable each year should be considered as a part of the annual rental deductible for the year in which they accrue.

This is not a case referred to in Article 23(a)—10—Rentals—of Regulations 86, by the following language:

> "If a leasehold is acquired for business purposes for a specified sum, the purchaser may take as a deduction on his return an aliquot part of such sum each year based on the number of years the lease has to run."

That language has reference to a bonus. Neither do these payments represent "the cost borne by a Lessee in erecting buidings or making permanent improvements", which may be prorated over the life of the building. Those are the situations covered by the cases relied upon by the Government and by the Circuit Court of Appeals. These recurring payments on the mortgage, paid as a part of the rent, are clearly "rentals or other payments required to be made as a condition to the continued use or possession for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title, or in which he has no equity".

We are confirmed in our view by the opinions in

Wyoming National Bank v. C. I. R., 28 B. T. A. 408, *Denholm and McKay Co. v. C. I. R.*, 39 B. T. A. ....., decided April 14, 1939, *Atlantic Coast Line R. R. Company v. C. I. R.*, 81 F. (2d) 309, Certiorari denied 298 U. S. 656, Rehearing denied 298 U. S. 691, and *Midtown T. Inc. v. C. I. R.*, 40 B. T. A. 116, No. 26, decided June 21, 1939, copy of which opinion is attached as Appendix One.

The last case cited is directly in point. There, the payments on the mortgage did not commence during the first years of the term of the lease, and the Lessee sought, nevertheless, to prorate the entire amount of the mortgage over the life of the lease and to deduct from the first year a proportionate amount of the mortgage thus spread over the full term of the lease, even though no actual payment on the mortgage became due during that year. The Commissioner of Internal Revenue contended that the actual amounts as they became due each year should be deducted as rental expense. He contended that since no payment on the mortgage became due during the first year, no expense could be deducted during that year. In other words, the Commissioner insisted that the amount of the mortgage should not be prorated over the lease, but that each year the actual amount payable in that year should be deducted. His contention there is ours here. The Board of Tax Appeals sustained the Commissioner's contentions.

Both the Commissioner of Internal Revenue and the Board of Tax Appeals have heretofore acquired a wide experience in questions of this character, and we think that the construction placed upon the statute and upon the Regulations of the Treasury by them in the *Midtown* case should receive consideration here.

We also call attention to the evidence in this case

which shows that in connection with the income taxes paid by the Mathias Trust Estate, one of the Lessors in the Hilton lease, the Commissioner ruled that the actual amounts paid by the Southwestern Hotel Company on the Pacific Mutual Life Insurance Company mortgage constituted income to the Lessor in the year when paid. In the letter from the Commissioner it was expressly stated that these payments should be considered as rent. The Commissioner did not then think that the payments on the mortgage should be prorated.

It would be inconsistent to hold that these payments in the actual amounts as paid should be considered as annual *rental income* in assessing income taxes against the Lessor, and should, at the same time, not be considered annual *rental expense* insofar as the Lessee is concerned.

Opposing counsel in the Court of Civil Appeals relied on *Duffy v. Central R. Co. of New Jersey,* 268 U. S 55, 45 Sup. Ct. 429. That case had to do with permanent improvements made by the Lessee. It did not deal with recurring payments made by the Lessee as rent for the continued use and possession of the premises. Clearly, the opinion in that case was sustained by the above quoted language from Treasury Regulations, Article 23(a)—10, which provides that the cost borne by Lessee in erecting buildings or making permanent improvements shall not be deductible as a business expense.

Galatoire Brothers v. Lines, 11 F. (2d) 878, 23 F. (2d) 676, is another case from which the United States seeks comfort. There is a clear distinction between that case and ours. There, we have the ordinary case of a bonus paid for a lease. If that lease had simply read, "The present lease is made in consideration of a bonus

of $19,707.63, payable January 1, 1918, and a monthly rental of $250.00 a month", it would have been quite easy to see that it presented the ordinary case of a bonus for a lease. It would be perfectly plain that the $19,707.63 did not constitute "rentals or other payments required to be made as a condition to the continued use or possession for purposes of the trade or business, of property to which the taxpayer has not taken, or is not taking title, or in which he has no equity". Yet the words above quoted are the exact equivalent in meaning of the following language in the lease, "The present lease is made for and in consideration of a monthly rental of Two Hundred and Fifty ($250.00) Dollars, payable monthly, and 50% of the profits of the restaurant conducted in said building during the year 1917, and the obligation on the part of said Lessees to board the Lessor and his family during the year 1917". One-half of the profits for the year 1917 amounted to $16,971.63, and the cost of the meals furnished to the Lessor amounted to $2736.00, which makes the total amount of $19,707.63, referred to in the assumed quotation from the lease. The agreement to pay the lump sum at the end of the first year was clearly a bonus to be paid in addition to the regular monthly rental.

The lease involved in *Baton Coal Company v. Commissioner of Internal Revenue,* 51 F. (2d) 469, was just as clearly one involving bonus payments. There, the lease was made on November 14, 1926. It provided for the payment of $50,000.00 in cash upon the inception of the lease and $51,250.00 in six months, and the payment of a royalty of thirteen cents a ton, with a minimum of $26,000.00 per annum. The two cash payments to be made within the first six months were clearly bonus payments. In fact, the Court said that the Commissioner of Internal Revenue rightly gave as the basis for his rul-

ing, "that those amounts represented a bonus paid in connection with the obtaining of the lease, and should be capitalized and the cost recovered over the life of the lease". The Court also quoted as a basis for its ruling an extract from the Treasury Regulations:

> "Article 110. Rentals—Where leasehold is acquired for business purposes for a specified sum, the purchaser may take as a deduction in his return an aliquot part of such sum each year based on the number of years the lease has to run."

The situation in our case does not come under the rule with reference to permanent improvements applied in *Duffy v. Central R. Company of New Jersey,* supra, nor under the rule with reference to bonus payments applied in *Galatoire Brothers v. Lines,* supra, and *Baton Coal Company v. Commissioner of Internal Revenue,* supra.

The Circuit Court of Appeals takes as a basis for its ruling Treasury Regulations 86, Article 23(a)—10, which reads:

> "Article 23(a)—10. Rentals—If the leasehold is acquired for business purposes for a specified sum, the purchaser may take as a deduction in his return an aliquot part of such sum each year, based on the number of years the lease has to run."

The Circuit Court of Appeals also relies on its own opinion in the recent case of *Main and McKinney Building Company v. Commissioner of Internal Revenue,* 113 F. (2d) 81. There are characteristics which are common to that case and ours, but we believe there are grounds of distinction which justify a different decision in our case.

In that case, it was clearly shown that the payments in question were a part of the purchase price of a lease. The basic instrument read:

> "Now therefore: Main Realty Company, hereinafter referred to as Grantor, for and in consideration of the sum of $65,547.30, to it in hand paid by Main and McKinney Building Company and the payments and obligations hereinafter mentioned, does hereby transfer, assign and convey unto the said Main and McKinney Building Company . . . the above described lease . . . together with the leasehold estate in the above described property . . . "

The annual payments of $10,000.00 each, payable over a period of years, while also referred to as rent, were expressly designated as a part of the purchase price for the transfer of the lease. Throughout the instrument the transaction was treated as a sale of the leasehold estate, and the parties were designated as "Grantor" and "Grantee". That case came squarely under the Treasury Regulations 86, Article 23(a)—10, which reads:

> "Art. 23(a)—10. Rentals. If a leasehold is acquired for business purposes for a specified sum, the purchaser may take as a deduction in his return an aliquot part of such sum each year, based on the number of years the lease has to run."

Our case is quite different. Southwestern Hotel Company is the original lessee, not the purchaser of the lease. This regulation, therefore, has no application. Our payments are rentals, required to be made as a condition to the continued use of the Hilton Hotel. We satisfy the very language of Section 23 of Revenue Act of 1934, c. 277, 48 Stat. 680. *Midtown Tower, Inc. v. C. I. R.*, 40 B. T. A. 116.

We have already pointed out that the mere fact that different amounts of rent are specified for different years does not require the fixing of an average rental over the life of the lease. The parties to the lease be-

lieved that property values generally, and especially the rental value of this hotel, would increase as business conditions improved from the 1929 depression. The parties, for that reason, provided for an ascending scale of rents during the first seventeen years, and then, in view of the obsolescence of the hotel building at the expiration of that period, fixed the rent for succeeding years at 6% on the then ground value of the property. We have shown that no attempt is made by the Government to actually determine what the average rent would be over the life of the lease, and, in fact, due to the method of arriving at the rentals payable after 1950, it would be impossible to do so.

There are practical difficulties which arise from adopting the Government's theory. If the lease should, for any reason, be cancelled within the next few years, the Southwestern Hotel Company would have no opportunity to charge out of its income the portions of the principal payments made in excess of the allowed annual deductions of $12,720.00. If the lessee should assign its lease, there is no practical way in which it might receive credit for excess amounts paid annually on the Pacific Mutual Life Insurance Company mortgage. We realize that these difficulties arise when a cash bonus has been paid, but we think these are reasons why the Court should be slow to approve the holding of the Court of Civil Appeals.

The whole theory of the income tax law is based upon the idea that each person should annually pay a tax, based upon the amount of his net income for year. As net income is received, the means are thus provided for the payment of the tax. The adoption of the Government's theory in our case would not comport with this theory,

and in practice would be ruinous to the Southwestern Hotel Company. That Company might earn each year a sufficient net operating profit to pay $12,000.00 a year on the mortgage during the first three years and $20,000.00 a year during succeeding years, but if it earned no more, it would soon face bankruptcy, if required to pay an income tax on all of the $12,000.00 above $4282.82 ($424,000.00 divided by ninety-nine) during the first three years, and all of the $20,000.00 above $4282.82 during the succeeding years, assuming that the $424,000.00 is prorated over the life of the lease.

In conclusion, we reiterate our contention to the effect that the payments on the mortgage did not constitute a bonus, such as was involved in *Galatoire Brothers v. Lines*, supra, in *Main and McKinney Building Company v. Commissioner of Internal Revenue*, supra, and in *Baton Coal Company v. C. I. R.*, supra, nor did they constitute payment for valuable improvements, such as described in the *Duffy* case. They constituted "rentals or other payments required to be made as a condition to the continued use or possession" of the Hilton Hotel property, "to which the taxpayer has not taken or is not taking title, or in which he has no equity". This case does not merely involve the sum of $989.24, and interest, here sued for. After the first three years the principal payments must be at least $20,000.00, and it is quite apparent that in all probability the amount involved in increased income taxes will materially exceed $2000.00 each year for approximately twenty-one years, especially in view of the rapidly rising income tax rates.

This Court has never clearly construed Section 23(a) of the Revenue Act of 1934, which is 26 U. S. C. A., Section 23, in a situation such as is involved here, and should

definitely state the rule applicable to cases of this character. We think it is entirely foreign to the general intent of the income tax law to compel the payment of a tax on gross income without permitting a deduction of the necessary annual expense, and we respectfully ask this Court to grant out petition in this case.

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